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**AGENDA ITEM 9a**

**TO: MEMBERS OF THE INVESTMENT COMMITTEE**

- I. SUBJECT:** New Internally Managed Portfolios – International Small / Micro Cap and Emerging Markets
- II. PROGRAM:** Global Equity
- III. RECOMMENDATION:** Approval to establish two new portfolios.
- IV. ANALYSIS:**

**Summary**

On February 19, 2008 in Agenda Item 9a (Attachment 1), Global Equity staff introduced the concept of expanding the breadth of internally managed equity index strategies by adding both an international small / micro cap fund and an emerging markets fund. The purpose of adding these funds is to provide an equity index investment alternative within each geographic and market capitalization segment contained within CalPERS' Global Equity benchmark. Access to a complete spectrum of index strategies will provide cost effective capacity and flexibility to assist in implementing the transition to the new market capitalization weighted Global Equity benchmark. Current CalPERS' staff has the ability, infrastructure and capacity to both manage and facilitate the back office activities related to these two funds. Incidental to internal management of an emerging markets fund is a proposal to utilize an external entity to perform a screening function to incorporate CalPERS' Emerging Equity Markets Principles ("Principles") (Attachment 2). An Opinion letter from Wilshire Associates is included (Attachment 3).

## **Background**

The Global Equity internal equity management team is successfully managing an array of index and enhanced / active strategies. These strategies contained approximately \$83 billion in assets at February 29, 2008. Included in this group are:

### **Domestic Portfolios**

- Wilshire 2500 - Index
- Wilshire 5000 Micro-cap Completion - Index
- Affiliate and Pooled S&P 500 - Index
- PREES Extended Market (Real Estate) - Index
- Russell 2500 - Index
- Dynamic Completion – Index
- Enhanced Index – Enhanced / active
- Fundamental – Enhanced / active

### **International Portfolios**

- FTSE All World Developed Markets (ex U.S.) – Index
- International FTSE EPRA / NAREIT (Real Estate) - Index
- Fundamental Developed Markets – Enhanced / active
- Structured Emerging Markets (Developmental) – Enhanced / active
- Fundamental Emerging Markets (Developmental) – Enhanced / active

The fundamental reasons underlying internal management are capitalizing on the relatively low cost structure of internal management and benefiting from the staff's ability to generate value added long term performance in a number of portfolios. The capability of the internal team also provides the maximum degree of flexibility for asset allocation purposes and facilitates management of all transition activity. Extending the internally managed opportunity set to international small / micro-cap and emerging markets index portfolios would serve to provide CalPERS with a complete global equity index management capability. In addition, these portfolios would provide a liquidity source within two market segments where capital flows can be disruptive and where external manager capacity is constrained.

**Implementation** – An array of portfolio management tools are utilized within the internal team. These tools, while under continual evolution and development, have proved capable of managing any type of index portfolio. Existing staff has the experience and ability to add two new portfolios. It needs to be recognized that additional portfolios, when combined with the activity of implementing the transition, is likely to utilize all available capacity within the internal equity team. CalPERS' back office staff has gained tremendous experience and capability through the activity attached to the two developmental emerging strategies. The

back office team has indicated that the work flowing from two new portfolios could be absorbed with the present resources.

Internal management of emerging markets assets is predicated on the acceptance of a mechanism to incorporate the CalPERS Emerging Equity Markets Principles. Staff has identified an outside vendor with the resources to execute a screen incorporating items relevant to the eight concepts contained in the "Principles". The vendor has a long history of executing research and constructing screens based on items such as those emanating from the Global Sullivan Principles and the International Labor Organization (ILO) Core Labor Conventions. The "Principles" as related to market structure, regulation, liquidity and trading are also reflected in a particular market's inclusion within the FTSE benchmark. CalPERS' staff considers issues such as liquidity and trading expense within the management of all funds.

Pros / Cons – Here is a listing of the positive and negative implications of adding an international small / micro-cap index portfolio, adding an emerging markets index portfolio and elevating the existing emerging portfolios:

#### Pros

- Cost saving – Average external manager fees paid in these market segments range from 25 to 40 basis points. This implies an external management cost of anywhere from \$2.5 to \$4.0 million for each \$1 billion in capital managed. External index management fees would be lower (2.5 to 5.0 basis points) but still likely cost between \$250,000 and \$500,000 for each \$1 billion in assets. Internal management saves this expense although it does not address any performance differences.
- Staff development – Expanding the types of assets being managed internally provides a greater depth of experience and also facilitates the development of perspectives that lead to active or value added processes.
- Aid further development of the tools and processes used to manage equity assets as the array of issues and data requirements becomes more demanding.
- Increases staff control of the transition to the new Global Equity benchmark.
- Avoid the need to seek outside managers and the attendant search and contracting time and expense.

#### Cons

- Expense of using an external source to perform a screen based on the CalPERS' Emerging Equity Market Principles. This expense is estimated at \$250,000.
- Increases the complexity of the internal program.
- Increases the organization's dependence on staff.

**Recommendation**

Staff request approval from the Investment Committee to establish an International Small / Midcap index fund, an Emerging Markets index fund and to incorporate the CalPERS' Emerging Equity Market Principles via a screening methodology.

**V. STRATEGIC PLAN:**

The Global Equity Strategic Plan will further the following goals of CalPERS Strategic Plan:

Goal VIII: Manage the risk and volatility of assets and liabilities to ensure sufficient funds are available, first, to pay benefits, and second, to minimize and stabilize contributions.

**VI. RESULTS/COSTS:**

The anticipated cost to implement a screen incorporating the CalPERS' Emerging Equity Market Principles is \$250,000 annually. An estimate of the savings from avoiding external management fees ranges between \$250,000 and \$4.0 million depending on the type of strategy for each \$1 billion in assets managed internally.

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